BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

POINT I

This Court should take jurisdiction to determine an important question of Federal law heretofore undecided by it.

This Court has never been presented with the question of what constitutes a transfer "wholly by operation of law" within the meaning of Schedule A-9, Title VIII of the Revenue Act of 1926 (as amended by Section 724A of the Revenue Act of 1932) and Treasury Regulations 71, Articles 35 (h) and 35 (r) (See App., pp. 29-32).

The only decisions of this Court, cited by the court below (R. 116), are: *Raybestos Manhattan, Inc.* v. *U. S.*, 296 U. S. 60; *Founders General Co.* v. *Hoey*, 300 U. S. 268; *Burnet* v. *Harmel*, 287 U. S. 103.

These decisions are not directly applicable to the facts in the case at bar but were merely cited to sustain the general propositions of law which the court below believed were enunciated by them. The Second Circuit apparently believed that the decisions in the *Raybestos* and *Founders* cases required the taxing statute to be strictly construed against the taxpayer.

Unlike the case at bar, where the transfers are conceded, both the *Raybestos* and *Founders* cases were concerned with whether or not a "transfer" had occurred within the meaning of the statute. The question in the instant case is whether or not the transfers were effected "wholly by operation of law".

Burnet v. *Harmel, supra,* was cited merely on the general principle of the controlling effect of local law and did not involve the tax statute here in question.

A determination of the question here presented is of the most vital and widespread importance both to the Government and the taxpayers.

The Series C-2 trust estate is but one of over five thousand other trusts of guaranteed certificated mortgages, each of which went through the same type of reorganization as that involved in this case. These other trusts embody approximately 15,000 properties and mortgages and total over $675,000,000 in principal amount. These trusts affect approximately 250,000 certificate holders, a large percentage of whom are persons of only moderate means and dependent for their incomes on these investments. (See Governor Lehman's message to Legislature, Legislative Document 1939, No. 78, and Chapter 745 of the Laws of New York 1933, as amended, Section 1796 of the Unconsolidated Laws of the State of New York.) (Appendix, pp. 34-38.)

Thousands of other transfers legally identical to the subject transfers will be directly affected by a determination of this case.

Point II.

The decision of the Circuit Court of Appeals for the Second Circuit is in direct conflict with that of the Ninth Circuit.

The decision below is in direct conflict with *U. S.* v. *Merchants National Trust & Savings Bank,* 101 Fed. (2d) 399, C. C. A. (Ninth Circuit). In that case a banking and trust company transferred certain stocks and securities as a result of the sale of its entire trust business to the Bank of America of California in accordance with Section 31 of the California Bank Act.

A tax was assessed and collected under the "transfer of legal title" provision of the Revenue Act of 1926, title VIII, Section 300 and Schedule A3, as amended, a provision iden-

tical to that dealt with in the instant case, except that Schedule A-3 concerns itself with transfers of stock and Schedule A-9 with transfers of bonds.

Section 31 of the California Bank Act, above referred to, provided that, upon the approval of the Superintendent of Banks of a sale of a trust business by one bank to another, the stocks and securities comprising such business would be deemed transferred to the purchasing bank as "by operation of law".

The court held that the transfers there in question were effected "wholly by operation of law", and consequently not taxable within the purview of Articles 35 (h) and 35 (r) of Treasury Regulations 71 and, further, that the California State Law was controlling on the question as to what constituted a transfer "wholly by operation of law".

The facts in the case at bar are indistinguishable in principle from the factual situation in the *Merchants* case.

In the instant case, the Second Circuit held that the New York State Law was not controlling upon the Federal Courts as to what constituted a transfer "wholly by operation of law." The Second Circuit further held that the transfers herein were taxable and not within the purview of the exceptions granted by Articles 35 (h) or 35 (r) (R. 116, 117).

The decisions of the Second Circuit in the case at bar and the Ninth Circuit in the *Merchants* case are thus in conflict in three independent respects, any one of which is sufficient to justify this Court in accepting jurisdiction. These conflicts involve the applicability of State law and the interpretation and application to the facts in the case at bar of Articles 35 (h) and 35 (r) of Treasury Regulations 71.

It is submitted that if jurisdiction is accepted by this Court, a favorable determination of any one of these conflicts will require a reversal of the judgment.

A.

THE CONFLICT REGARDING THE APPLICABILITY OF STATE LAW.

The decisions of the Second and Ninth Circuits are diametrically opposed regarding the controlling effect of State Law as to the nature of the transfers. Both courts adopt the doctrine of "necessary implication" as enunciated by *Burnet* v. *Harmel*, 287 U. S. 103, and reach opposite conclusions as to whether the taxing statute and Articles 35 (h) and 35 (r) by necessary implication make their operation dependent upon State law. Proceeding from this divergence of basic construction and applying the law to sets of facts which are legally identical, the Ninth Circuit accepted State law as controlling on the question of whether the transfers were "wholly by operation of law" and the Second Circuit completely rejected it.

B.

THE CONFLICT REGARDING ARTICLE 35 (H) OF TREASURY REGULATIONS 71.

While the facts in the *Merchants* case and in the case at bar are legally identical, within the meaning of Article 35 (h), nevertheless the Ninth Circuit held that Article 35 (h) afforded an exemption and the Second Circuit held to the contrary.

In the *Merchants* case, the Ninth Circuit found that the transfers were from a named resigned trustee to a named substituted Trustee appointed in accordance with the terms of the trust agreement and therefore conformed precisely to the requirements of Article 35 (h) which exempted such transfers from tax. The court found that since the California Banking Act was in existence at the time the trust agreement was executed, the provisions for the substitution

of the Trustees, as contained in the statute, were incorporated in the trust agreement as a matter of law. The Act provided for the substitution of trustees in a manner which brought the transfers within the provisions of Article 35 (h).

Similarly, the facts in the case at bar precisely conform to the facts in the *Merchants* case insofar as the requirements of Article 35 (h) are concerned. There was a transfer from a named resigned trustee (the Mortgage Commission) to a named substituted Trustee (the petitioners herein). The substitution of the Trustees in both cases was pursuant to the statutes of the State in which the transfers occurred.

The Mortgage Commission Act (which incorporated part of the provisions of the Schackno Act by reference, Article VIII, Section 1769 Unconsolidated Laws of New York) was the trust instrument pursuant to which the Mortgage Commission derived all of its powers in the operation of the trust estate for the benefit of the *cestuis que trustents*, the certificate holders.

The substitution of the Trustees was in accordance with the provisions of this trust instrument (the Mortgage Commission Act).

People v. *Title and Mortgage Guaranty Company*, 264 N. Y. 69, 79, 89.

Judge Goddard, holding for the petitioners in the District Court, said:

> "* * * the legal relationship between the Superintendent of Insurance and the Mortgage Commission on one side, and the certificate holders on the other, was that of Trustee and cestui. See People *v.* Title and Mortgage Company, *supra*, at pp. 79 and 89. Plaintiffs therefore took over the securities as Successor

Trustee and under the authority of United States *v.* Merchants National Trust and Savings Bank, *supra*, a transfer to them is not taxable" (R. 102).

C.

THE CONFLICT REGARDING ARTICLE 35 (R) OF TREASURY REGULATIONS 71.

The transfers involved in the *Merchants* case were held to have been effected "wholly by operation of law" within the meaning of Article 35 (r) and therefore exempt. As the petitioners will demonstrate in POINT IV, *infra*, the facts in the instant case are so analagous to those in the *Merchants* case, that the same legal result should properly follow in the case at bar. Notwithstanding, the Second Circuit concluded that Section 35 (r) of Regulations 71 had no application and that the transfers were taxable.

POINT III.

The Circuit Court of Appeals for the Second Circuit has decided a Federal question in conflict with applicable decisions of this Court concerning the controlling effect of State law.

The law of the State of New York is well settled that transfers identical in legal effect with the transfers in the instant case are by operation of law.

Terminals Transportation Corp. v. *State*, 169 Misc. 708, 8 N. Y. S. Supp. (2d) 282, affd. 14 N. Y. Supp. (2d) 493, 281 N. Y. 889 #23;

Electric Bond and Share Company v. *State*, 249 App. Div. 371, Affirmed 274 N. Y. 625;

Rockefeller Foundation v. *State*, 144 Misc. 460, 258 N. Y. Supp. 812;

Phelps-Stokes Estates v. *Nixon*, 222 N. Y. 93.

The Circuit Court of Appeals for the Second Circuit has recognized that:

> "The New York decisions in Terminals & Transportation Corp. *v.* State, 169 Misc. 703, aff'd 257 App. Div. 1028, and Electric Bond & Share Co. *v.* State, 249 App. 371, aff'd 274 N. Y. 625, that transfers similar to those here were by operation of law * * *" (R. 116).

While the taxing statute with which we are here concerned does not expressly make its operation dependent upon State law, Articles 35 (h) and 35 (r) of Treasury Regulations 71 do so by clear and necessary implication.

Burnet v. *Harmel,* 287 U. S. 103;

U. S. v. *Merchants National Trust and Savings Bank,* 101 F. (2d) 399.

The reference in Article 35 (r) to transfers "wholly by operation of law" is explicable only by the law which effectuates the transaction, the legal effect of which is to be determined. Thus, Article 35 (r) contains the general, necessary implication that the law creating the transaction must define and determine its legal effect. Should the nature of the transaction sought to be taxed be determined by Federal law, then, by necessary implication, the Federal law must be adopted to ascertain whether the transfer is "wholly by operation of law". Conversely, as in the case at bar, should the transfer in question be effectuated by State law, then, by necessary implication, the State law must be adopted in determining whether the transfers were effected "wholly by operation of law". This is particularly true where a State law, which is *sui generis,* initiated and by its very terms effectuated the transfer. Once the State law defines the legal effect of what it has accomplished, this determination is controlling on the Federal courts and the re-

maining question is whether the Federal statute taxes the transaction so determined.

Morgan v. *Commissioner*, 309 U. S. 78;
Lang v. *Commissioner*, 304 U. S. 264, 267;
Blair v. *Commissioner*, 300 U. S. 5, 9, 10;
Freuler v. *Helvering*, 291 U. S. 35, 45;
U. S. v. *Merchants National Trust and Savings Bank*, 101 F. (2d) 399;
Legg's Estate v. *Commissioner*, 114 F. (2d) 760;
Dayton & Michigan R. R. Co. v. *Commissioner*, 112 F. (2d) 627;
Leser v. *Burnet* (4th Cir.), 46 F. (2d) 756, 760.

In *Legg's Estate, supra*, the Fourth Circuit has recently summarized the controlling authority concerning the applicability of State law as follows, at page 763:

> "And the application of this rule is not affected by the fact that a question of federal taxation is ultimately involved, for while we look to federal decisions as authoritative in interpreting the federal statute imposing the tax, we look to the law of the state as laid down by its courts in determining whether there has been such a transfer of property as is subject to the tax under that interpretation. 'State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed'" (citing authorities).

Aside from the impossibility of determining the question involved without resorting to and adopting the State law defining the nature of the transfer, Article 35 (r) patently indicates that the statute contemplated the adoption of State law by the very example which it sets forth, i. e. the transfer of stock from decedent to executor. This example definitely contemplates a transfer by operation of the law of a State. Congress does not and probably has no constitutional power

to regulate or provide for the transfer of property at death. Since the example of a transfer "wholly by operation of law" (described in the Regulations) is necessarily a transfer by operation of State law, Article 35 (r) certainly cannot be construed to exclude transfers wholly by operation of State law. The Treasury Department has recognized this and, in fact, ruled that whether or not a given transfer of legal title to shares of stock results wholly from operation of law depends upon the effect given to the transaction by the law of the State in which the transaction occurs.

O. D. 127;
S. T. 5-21-250.

While the Government relied upon *Cliffs Corporation* v. *U. S.*, 103 F. (2d) 77, C. C. A. Sixth Circuit, certiorari denied, 60 S. Ct. 91, to support its contention that the State law is not controlling in this case, the court below tacitly recognized the inapplicability of that case to the facts herein by not even citing the *Cliffs* case in its opinion.

The court, in the *Cliffs* case, recognized the doctrine contended for by the petitioners herein when it said:

> "In many Federal taxing statutes the tax is made to follow at the time the State law creates a legal interest. In such cases the state law will be applied to determine such interest but the Federal Statute determines when and how it shall be taxed * * *."

Congress, in enacting the Rules of Decisions Statute (U. S. Code, title 28, Sec. 725), has specifically provided and indicated its intent that:

> "The laws of the several states, except where the Constitution, treaties, or statutes of the United States otherwise require or provide, shall be regarded as rules of decision in trials at common law, in the courts of the United States, in cases where they apply."

This Court has given effect to that intent by consistently holding that the Federal courts are bound by State law, except where a Federal statute specifically requires or provides otherwise:

Erie R. Co. v. *Tompkins*, 304 U. S. 64;
Vandenbark v. *Illinois Glass Co.*, 61 S. Ct. 347 (not yet reported in United States reporter);
Morgan v. *Commissioner*, 309 U. S. 78;
Lang v. *Commissioner*, 304 U. S. 264, 267;
Blair v. *Commissioner*, 300 U. S. 5, 9, 10;
Dayton & Michigan R. R. v. *Commissioner*, 112 F. (2d) 627.

Point IV.

The transfers herein were not taxable under the Federal law.

Petitioners have maintained in the preceding point that Federal law requires the application of State law in determining the nature of the transfers here in question. However, even assuming that State law is not controlling on the nature of the transfers, they must be held exempt from taxation under the Federal law on any one of two separate and distinct bases. They should have been exempted from taxation under the provisions of Article 35 (h); and similarly under the provisions of Article 35 (r).

A.

The Transfers Fit Precisely Within the Exemption Afforded by Article 35 (h).

To render a transfer not taxable as having been effected "wholly by operation of law", Article 35 (h) requires three essential elements:

(1) a named, resigned Trustee;

(2) a named substituted Trustee, and

(3) each appointed in accordance with the terms of the original trust agreement.

In POINT II under Subdivision B, *supra*, we have established that these essential elements existed in these transfers. It is a necessary corollary, therefore, that the provisions of the statute automatically operate and the court must find the transfers were effected "wholly by operation of law" and are consequently not taxable.

The subject transfers precisely and realistically represent the situation contemplated by the statute. The trust agreement (Mortgage Commission Act) specifically contemplated and anticipated the very succession of trustees which in fact occurred. Thus, the substituted trustee was not only appointed in accordance with the original trust instrument, (the Mortgage Commission Act), but the original trust instrument by its terms contemplated such appointment.

People v. *Title & Mortgage Guarantee Co.* (1934) 264 N. Y. 69;

To the same effect, see
Matter of New York Title & Mortgage Co. (1934) 264 N. Y. 475.

In its opinion, the Court below completely disregarded the application of Article 35 (h) to the instant transfers, although no sound and cogent reason has yet been advanced as to why these transfers are not governed by it.

B.

THE TRANSFERS WERE WHOLLY BY OPERATION OF LAW AND CONSEQUENTLY EXEMPT FROM TAXATION PURSUANT TO ARTICLE 35 (r).

The court below, in arriving at its conclusion that the

taxing statute should be applied strictly to the transfers in suit, said:

> "The Supreme Court construed the Statute imposing the transfer tax literally in *Raybestos-Manhattan Inc.* vs. *United States,* 296 U. S. 60, and *Founders General Corp.* v. *Hoey,* 300 U. S. 268, and was altogether strict in subjecting the transfers to a tax." (R. 116).

While the words just quoted were applicable to the facts in the *Raybestos* and *Founders* cases, this Court, in *White* v. *U. S.,* 305 U. S. 281, has very recently ruled that neither the taxpayer nor the taxing authority should be favored in interpreting taxing statutes but that it is the duty of the courts to decide fairly what the construction of the statutes shall be.

In substantiation of its position regarding the construction to be placed upon the taxing statute, the court cited *Koppers Coal & Transportation Company* v. *U. S.,* 107 F. (2d) 706, decided by the Circuit Court of Appeals for the Third Circuit. It is for this reason that we advert to that case, since neither from the standpoint of the facts nor of the legal principles enunciated does that case have any similarity to the case here presented. There are numerous grounds of distinction between the cases. It is only necessary to refer to the fact that the transfers there presented were specifically taxable under Article 34 (r), a Regulation in no way applicable to or involved in this case. The Court in the *Koppers* case properly so held and aptly stated:

> "Such a transfer of title is within the express language of Schedule A3 of Section 800 and is precisely the example given in Article 34 (r) of Treasury Regulations 71."

The court below considered, therefore, that any voluntary act was sufficient to take the transfers out of the operation

of Article 35 (r) and render them taxable. The two-thirds consent of the certificate holders (required by the statute) was relied upon as the single voluntary act which prevented the transfers from being exempt from taxation as "wholly by operation of law" within the meaning of Article 35(r). The fallacy in taxing these transfers because of the two-thirds consent required by the statute can best be clarified by an analysis of the circumstances surrounding their execution. In order properly to comprehend the significance of this consent, it is necessary to review the manner in which the transfers were effected.

A judicial decree effected the transfers herein taxed after a series of legal steps activated by the machinery of the Mortgage Commission Act.

The Mortgage Commission Act authorized the Mortgage Commission to promulgate a plan of reorganization on its own initiative without any act on the part of the *cestuis*. In the case at bar, the transfers were consummated according to the steps indicated by the statutory machinery; the promulgation of the plan and the application to the court for the approval thereof by the Mortgage Commission; the obtaining of two-thirds consent of the certificate holders in the event that an interlocutory order of approval was made by the court; the making of a final order approving the plan and finally, the appointment and qualification of the Trustees. Upon the qualification of the Trustees, the transfers were automatically effected under and pursuant to the court order approving the plan and title immediately vested in the Trustees without further act or instrument (R. 50-51).

The plan itself provides that:

> "upon the execution of the Declaration of Trust * * * all of the securities against which such mortgage investments have been issued * * * shall immediately vest in the Trustees" (R. 50-51).

The implication is clear from the opinion of the court below that, were it not for the two-thirds consent of the certifi-

cate holders, the transfers herein were effected wholly by operation of law and consequently not taxable. However, when the true nature of this consent is analyzed, it is readily discernible that in no wise did such consent constitute a voluntary act, the effect of which would render the transfers taxable.

The late Mr. Justice Frankenthaler, who was largely responsible for the existing body of law in this field, expressed the belief that certificate holders had no alternative but to approve the plan. He said in *Matter of New York Title and Mortgage Company* (Series N-81), 1[illegible] Misc. 865 at page 866:

> "It may well be that their execution of consents to the proposed plan was due to the fact that they were faced with the alternative of either approving the plan submitted to them or else going without any plan at all."

See also *People* v. *Title & Mortgage Guaranty Co.*, 264 N. Y. 69;

Terminals Transportation Corp. v. *State*, 169 Misc. 708, 8 N. Y. S. (2d) 282, affd. 14 N. Y. S. (2d) 493, 281 N. Y. 889 #23.

See also opinion of Mr. Justice Goddard in the District Court in this case. (R. 99).

A failure to consent to the plan on the part of the certificate holders would have meant that the future administration of the trust estate was completely undetermined. Moreover, the Mortgage Commission could not continue to exist beyond 1939. The certificate holders were, therefore, in a position of uncertainty as to how or by whom their investments would be administered in the event that they rejected the plan. In this connection, it is significant to note that the Mortgage Commission was created as a temporary agency to administer, liquidate and turnover to permanent

liquidating trustees the issues administered by it before its existence terminated. In a speech to the Legislature of the State of New York made on March 21, 1939, regarding the Mortgage Commission, Governor Lehman said:

> "It was necessary for the Commission immediately (upon its creation) to set up an organization * * * to promulgate reorganization proceedings for the appointment of Trustees to act for the certificate holders in the future." (parenthesis ours).

It was clear that if certificate holders were to leave their investments with the Mortgage Commission for even a limited period of time it would have been disastrous and resulted in complete chaos in the future administration of the trust estate. The powers granted to the Mortgage Commission by its trust agreement (the statute) were so limited that it was unable properly to administer a group series organized in the manner of the Series C-2 Issue. Illustrative of one of its limitations was the requirement to obtain court approval upon consent of two-thirds (or failure to dissent of one-third) of the certificate holders for each sale, modification, extension or adjustment made in connection with a mortgage or a property. This trust estate consists of over 100 mortgages and properties involving investments ranging from less than $5000 to over $2,000,000 in principal amount (R. 35-39, incl.). To have required, in each transaction, the consent of two-thirds of 7500 certificate holders scattered widely over the United States would have been totally impractical and prohibitively expensive. When it is realized that the Mortgage Commission, at that time, did not even have the power to satisfy a mortgage, when the full principal plus accrued interest were offered in payment thereof, the utter impossibility of permitting the trust estate to remain with them becomes apparent.

While the Commission administered the Series C-2 issue, a mortgagor actually did attempt to pay off the full principal amount of his mortgage and the payment was refused because of the statutory inability of the Mortgage Commission to accept the same. Thus, the Mortgage Commission was a liquidating trustee unable to liquidate.

The plan of reorganization (R. 33-56, incl.), however, removed all of these limitations and gave to the prospective Trustees a facility and latitude of powers which were required for an orderly and effectual administration and liquidation of the trust estate.

A further analysis of the so-called "choice" of the certificate holders by the two-thirds consent required by the statute reveals that such consent did not cause or insure an approval of the Plan by the court. If, after the required consents had been obtained, the court did not see fit to approve the Plan, it was not required to do so, and conversely, if the certificate holders who had filed consents desired to withdraw them, they could not have done so.

In re New York Title and Mortgage Company (Series N81), 154 Misc. 865, 278 N. Y. Supp. 556.

Furthermore, if the plan were approved in accordance with the statutory machinery, even though one-third of the certificate holders opposed the plan they were bound thereby. Certainly the certificate holders who refused to consent and in fact opposed the plan cannot be said to have performed a "voluntary" act.

Weil v. *President and Directors of Manhattan Company,* 275 N. Y. 238.

The true meaning of the "choice" given to the certificate holders was that they were compelled to accept the plan or to have no plan at all, which essentially means no "choice" at all.

It has repeatedly been held that it is the underlying essence of a transaction which determines its taxability.

See:

Helvering v. *Tex-Pen Oil Co.*, 300 U. S. 481, 493, 57 S. Ct. 569, 81 L. Ed. 755;

Bowers v. *Lawyers Mortgage Co.*, 285 U. S. 182, 188, 52 S. Ct. 350, 76 L. Ed. 690;

United States v. *Phellis*, 257 U. S. 156, 168, 42 S. Ct. 63, 66 L. Ed. 180;

Commissioner of Int. Rev. v. *Schumacher Wall Bd. Corp.*, 9 Cir., 93 F. (2d) 79, 81.

A realistic analysis of this situation may be found in the following excerpt from the Harvard Law Review in its discussion of the opinion below in this case.

> "And indeed a less meticulous concern for the voluntary aspect of the rehabilitation could have been justified by a realization that the required approval is often little more than a reluctant choice over the unattractive alternative of permitting the Mortgage Commission to continue with enforced liquidation. See Terminals & Transportation Corp. *v.* State, 169 Misc. 703, 705, 8 N. Y. S. (2d) 282, 284, 285 (Ct. Cl. 1938), 54 H. L. R. 890, at 891, 892."

Conclusion.

The taxpayers in this case consist of investors of small and moderate means who invested in guaranteed mortgage certificates not as a speculative venture but to conserve their limited assets for future security. They were deluded into believing that impregnable assets and guaranties buttressed their small investments which were legal for trust funds in the State of New York.

The State created agencies to mitigate the losses sustained as a result of the debacle of 1933. These agencies acted as mere conduits to permanent liquidating Trustees,

the ultimate salvaging agents. It is upon this last salvaging operation initiated and effectuated by State law that the Government seeks to impose a further burden. It could not have been the intention of Congress to tax as a voluntary act a transfer resulting through the operation of State machinery designed to retrieve the remnants of their investments.

Respectfully submitted,

EUGENE J. MORRIS,
Counsel for Petitioners.

EUGENE J. MORRIS,
HERBERT BURTON BRILL,
WILLIAM E. RUSSELL, JR.,
THEODORE TANNENWALD,
ALLAN ROGOW,
Of Counsel.